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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner
v.
HUGHES PROPERTIES, INC.,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF OF TRANSAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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TABLE OF CONTENTS

	Page
PRELIMINARY STATEMENT	1
INTEREST OF AMICUS CURIAE	2
SUMMARY OF ARGUMENT	2
ARGUMENT	4
I	
RESPONDENT MET THE "ALL EVENTS" TEST AT THE TIME IT DEDUCTED ITS PROGRESSIVE SLOT MACHINE LIABILITIES	4
II	
THE COURTS BELOW PROPERLY GAVE SUBSTANTIAL WEIGHT TO RESPONDENT'S UNCONTROVERTED EVIDENCE THAT ITS ACCOUNTING METHOD COMPLIES WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES	8
III	
PETITIONER'S RELIANCE ON *THOR POWER TOOL CO. V. COMMISSIONER* AND *AMERICAN AUTOMOBILE ASS'N V. UNITED STATES* IS MISPLACED	21
CONCLUSION	29

TABLE OF AUTHORITIES

Cases

Pages

American Automobile Ass'n v. United States, 367 U.S. 687 (1961) 21, 27, 28, 29

Artnell Company v. Commissioner, 400 F.2d 981 (7th Cir. 1968) 11, 17, 28

Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957) 20, 27

Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938) 6

Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955) 20

Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.) (per curiam), *cert. denied*, 429 U.S. 867 (1976) 11, 15, 17, 28

Brown v. Helvering, 291 U.S. 193 (1934) 13

Burck v. Commissioner, 533 F.2d 768 (2d Cir. 1976) 8

Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978) (per curiam), *cert. denied*, 410 U.S. 907 (1979) 8, 18

Commissioner v. Idaho Power Company, 418 U.S. 1 (1974) 3, 9, 16

Corbin v. O'Keefe, 87 Nev. 189, 484 P.2d 565 (1971) (per curiam) 6

Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959) 5, 7, 14

Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944) 15

Eastman Kodak Co. v. United States, 534 F.2d 252 (Ct. Cl. 1976) 6, 7, 12

Flamingo Resort, Inc. v. United States, 485 F. Supp. 926 (D. Nev. 1980), *aff'd*, 664 F.2d 1387 (9th Cir. 1982) 6, 15

Fort Howard Paper Co. v. Commissioner, 49 T.C. 275 (1967) 17

Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951) 5, 16

Cases

Pages

Haynsworth v. Commissioner, 68 T.C. 703 (1977), *aff'd*, 609 F.2d 1007 (5th Cir. 1979) 5

Hughes Properties, Inc. v. United States, 5 Cl. Ct. 641 (1984), *aff'd*, 760 F.2d 1292 (Fed. Cir. 1985) .. 9, 10

Lawyer's Title Guaranty Fund v. United States, 508 F.2d 1 (5th Cir. 1975) 7

Molsen v. Commissioner, 85 T.C. 485, 5 T.C. No. 28, Tax Ct. Rep. (CCH) Dec. 42,406 (September 26, 1985) 17

Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969) 6, 7, 8, 11, 13, 18

Orange & Rockland Utilities, Inc. v. Commissioner, 86 T.C. No. 14, Tax Ct. Rep. (CCH) Dec. 42,884 (February 18, 1986) 10

Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955) 17, 20

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971) .. 23

Supermarkets General Corp. v. United States, 537 F. Supp. 759 (D.N.J. 1982) 17

Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) 14, 21, 22, 23, 24, 25, 26, 27

Transwestern Pipeline Co. v. United States, 639 F.2d 679 (Ct. Cl. 1980) 17

Travis v. Commissioner, 406 F.2d 987 (6th Cir. 1969) 15

United States v. Anderson, 269 U.S. 422 (1926) 2, 6, 9, 11, 13, 16, 24

W.S. Badcock Corp. v. Commissioner, 491 F.2d 1226 (5th Cir. 1974) 11, 17, 18

Weisbrod v. Fremont Hotel, Inc., 74 Nev. 227, 326 P.2d 1104 (1958) (per curiam) 6

Pages

Statutes and Regulations

Internal Revenue Code of 1954 (26 U.S.C.):
§ 170 25
§ 446(a) 12, 23
§ 446(b) 2, 3, 4, 8, 10, 12, 19, 24
§ 446(c) 2, 12
§ 452 ..... 19, 21
§ 462 ..... 19, 20
Treas. Reg. (26 C.F.R.):
§ 1.446-1(a)(2) 3, 12
§ 1.446-1(c)(1)(ii) 3, 13, 14, 25
§ 1.461-1(a)(2) 3
§ 1.471-2(c)(i) 22
Nev. Gaming Reg. (1972):
§ 5.110 5

Pages

Other Authorities

H.R. Rep. No. 293, 84th Cong., 1st Sess.; *reprinted in* 1955-2 C.B. 852 ..... 20, 21

S. Rep. No. 372, 84th Cong., 1st Sess.; *reprinted in* 1955 U.S. Code Cong. and Ad. News 2046 ..... 19, 20

Audit and Accounting Guide Prepared By The Gaming Industry Special Committee of the American Institute of Certified Public Accountants, "Audits of Casinos" (1984) 9, 26

Bersh and Nadel, *The Dilemma of Conformity — Tax and Financial Reporting,* 36 Inst. on Fed. Tax'n 529 (1978) 19

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Financial Accounting Standards Board, Statement of Financial Concepts No. 2: Qualitative Characteristics of Accounting Information, ¶ 95, *reprinted in* 1 FASB Accounting Standards Original Pronouncements as of June 1982 ..... 23, 24

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Nolan, *The Merit of Conformity of Tax to Financial Accounting,* 50 Taxes 761 (1979) 22

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BRIEF OF TRANSAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

PRELIMINARY STATEMENT

Transamerica Corporation ("Transamerica") submits this brief as *amicus curiae* in support of Respondent in this proceeding. All parties to this proceeding have given their written consent to the filing of this brief. Copies of such written consents have been filed with the Clerk of the Court.

INTEREST OF AMICUS CURIAE

Transamerica, a diversified insurance and financial service company, files a consolidated federal income tax return annually on behalf of itself and all members of its affiliated group. Transamerica and over 150 members of its affiliated group calculate their income on the accrual method of accounting. Neither Transamerica nor any member of its affiliated group operates casinos. However, like Respondent, Transamerica has had and currently has disputes with the Commissioner of Internal Revenue and the United States over the proper application to Transamerica's tax returns of the accrual method of accounting. One such dispute is currently pending in both the United States District Court for the Northern District of California and the United States Tax Court. *Transamerica Corporation v. United States*, Nos. C-84-0877 TEH and C-85-2543 TEH (N.D. Ca.); *Transamerica Corporation v. Commissioner*, Docket Nos. 16460-79, 5909-82 and 29985-83 (United States Tax Court).

SUMMARY OF ARGUMENT

Under the accrual method of accounting, taxpayers report income and take deductions not when they receive or make payment but when they obtain a right or incur an obligation. Congress authorized taxpayers to use the accrual method of accounting because it provides a clearer reflection of taxpayers' income than does the cash method. I.R.C. § 446(c); *United States v. Anderson*, 269 U.S. 422, 440 (1926). The accrual method of accounting accomplishes this goal by allowing taxpayers to use "scientific accounting principles" to charge "against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *Id.*

Transamerica files this *amicus curiae* brief because the position of the United States, particularly that expressed at pages 19-29 of the Brief for the United States ("Br."), if accepted by this Court, would fundamentally alter the accrual methed of accounting, converting it from a method which seeks to match in each taxable year the revenues and related expenses of a taxpayer to a hybrid method of accounting, part accrual and part cash, in which the Commissioner of Internal Revenue (the "Commissioner") will have discretion to distort taxpayers' income in order to increase the government's revenues. Petitioner's position is inconsistent with the purposes of the accrual method of accounting, with good accounting practice and with the reasoning of this Court in its prior decisions in analogous areas of the Internal Revenue Code. *See, e.g., Commissioner v. Idaho Power Company*, 418 U.S. 1 (1974).

Transamerica urges this Court to rule for Respondent. Petitioner argues that Respondent's deduction of its progressive slot machine liabilities does not clearly reflect income under Section 446(b) of the Internal Revenue Code because Respondent allegedly has not met the "all events" test set forth in Treasury Regulations §§ 1.446(c)(1)(ii) and 1.461-1(a)(2). Respondent, however, has demonstrated that it satisfies the "all events" test because the Nevada Gaming Commission imposes upon it an unconditional liability to pay the amounts showing at year end on the payoff indicators of its progressive slot machines. Respondent has also demonstrated, through uncontradicted expert testimony, that its method of accounting properly matches its income and expenses and, in the words of this Court in *Commissioner v. Idaho Power Company*, "comports with accounting and taxation realities." 418 U.S. at 10. In close cases under the "all events" test, the Internal Revenue Code, by

explicitly sanctioning the accrual method of accounting, suggests that this Court should look to such accounting and taxation realities to determine whether the Commissioner has properly concluded that the taxpayer's method of accounting does not clearly reflect its income under Section 446(b). Respondent has shown that its accounting method matches its income and expenses precisely: As gamblers deposit coins into progressive slot machines, the casino recognizes income. Simultaneously and automatically, the expenses attributable to the earning of that income are registered on the progressive slot machine indicator to be deducted as the related income is recognized. Petitioner offers no concrete evidence to suggest that Respondent's deduction of its progressive slot machine liabilities distorts its income. In the absence of such evidence, Petitioner cannot disallow Respondent's deductions.

ARGUMENT

I. Respondent Met The "All Events" Test At The Time It Deducted Its Progressive Slot Machine Liabilities.

Petitioner argues that Respondent fails to meet the "all events" test largely because until a gambler makes a winning pull no single gambler could make a claim against Respondent as a result of its progressive slot machine liability and because Respondent could avoid payment of this liability if it ceased its casino operations before the winning pull. (Br. 11-13) If Petitioner is to prevail, it can only be because the absence of a specific gambler who can make a claim or the ability of Respondent to avoid a claim by closing its casino prevents Respondent from establishing the fact of liability under the "all events" test.

Petitioner's application of the "all events" test to the facts of this case, however, focuses on the wrong relationship. The relationship between the casino and the lucky gambler who makes the winning pull does not create the liability deducted by Respondent. That liability arises from the relationship of Respondent to the Nevada Gaming Commission. The Gaming Commission issued Respondent a license to operate a casino. Respondent, in turn, obligated itself to abide by all Nevada Gaming Regulations. When Respondent places progressive slot machines in service, it does so subject to the liability imposed upon it by Reg. § 5.110 of the Nevada Gaming Regulations. Joint Appendix (hereinafter "J.A.") 56. Under Reg. § 5.110, Respondent may not turn back the payoff indicator on its progressive slot machines and may not remove them from the floor without transferring the amounts to other machines until the amount showing on the payoff indicator has been won. J.A. 55-57. If Respondent violates this regulation, the Nevada Gaming Commission can fine it or suspend or revoke its license. J.A. 53-55. Unless it ceases its casino business, Respondent cannot avoid payment of this liability. The winning pull of the slot machine merely identifies the time of payment and the identity of the payee of this liability.

Liabilities similarly imposed by governmental regulation have been recognized as properly deductible by numerous courts construing the "all events" test, even in circumstances where the specific payee or time of payment cannot be determined. *Harrold v. Commissioner*, 192 F.2d 1002, 1004-06 (4th Cir. 1951); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 934-37 (3d Cir. 1959); *see also Haynsworth v. Commissioner*, 68 T.C. 703, 712 (1977), *aff'd*, 609 F.2d 1007 (5th Cir. 1979). The fact that as of the end of the tax year no gambler yet had a legally enforceable right to collect the jackpot is irrelevant; legal

enforceability is not a prerequisite to fixing the fact of liability under the "all events" test. *Eastman Kodak Co. v. United States*, 534 F.2d 252, 257 (Ct. Cl. 1976); *cf. Barker v. Magruder*, 95 F.2d 122, 123 (D.C. Cir. 1938); *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 934-36 (D. Nev. 1980), *aff'd*, 664 F.2d 1387 (9th Cir. 1982); *see also United States v. Anderson*, 269 U.S. 422 (1926) (holding that taxpayer should have deducted its liability for a tax the year before the tax was assessed).

Nevada law concerning the enforceability of gambling debts demonstrates the faulty logic of Petitioner's contention that when the only sanction on the casino is the threat of loss of its license the "all events" test cannot be met. Petitioner concedes that once a gambler makes a winning pull Respondent may deduct the amount showing at the time of the pull on the payoff indicator. (Br. 15) Under Nevada law, however, the winning gambler cannot enforce the debt against the casino. *Corbin v. O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971) (per curiam); *Weisbrod v. Fremont Hotel, Inc.*, 74 Nev. 227, 326 P.2d 1104 (1958) (per curiam); *Flamingo Resort, Inc.*, 485 F. Supp. at 930. If the casino refuses to pay, the gambler must pursue administrative remedies through the Nevada Gaming Commission, J.A. 71-72, which has powers to sanction the casino for failure to pay identical to those it has to sanction the casino if the casino prematurely removes a progressive slot machine from play. J.A. 59; *Weisbrod*, 326 P.2d at 1104-05. The winning pull in no way alters Respondent's liability; it merely identifies the time for payment and the payee. The "all events" test, however, does not require an accrual basis taxpayer to wait until the time of payment has been identified to deduct a liability. *Eastman Kodak Co.*, 534 F.2d at 258; *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 405-06 (5th

Cir. 1969). Nor does it require that the payee be specifically identifiable. *Denise Coal Co.*, 271 F.2d at 936.

The theoretical possibility that Respondent may avoid payment of its liability by ceasing operation of its casino similarly does not alter the fact that its liability is fixed when it places its progressive slot machines in operation. Any accrual basis taxpayer may go out of business before paying its liabilities. The courts have consistently held that the possibility that a taxpayer will go out of business cannot prevent the taxpayer from establishing the fact of liability under the "all events" test. *See, e.g., Lawyer's Title Guaranty Fund v. United States*, 508 F.2d 1, 6 (5th Cir. 1975); *Eastman Kodak Co.*, 534 F.2d at 260, n.12. Any other holding would destroy the accrual method of accounting. *Id.* Moreover, if the Commissioner had had evidence that a real risk existed at the end of any tax year that Respondent would avoid payment of its liability by ceasing its casino operations, the Commissioner could have disallowed the deduction even though Respondent met the "all events" test. *Mooney Aircraft, Inc.*, 420 F.2d at 410.[1]

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[1] *Mooney Aircraft, Inc.* also disposes of Petitioner's contention that Respondent fails to meet the "all events" test because of its discretion to set the slot machine odds so that the slot machines will be unlikely to pay off for many years. (Br. 12) Any taxpayer can negotiate its contracts so that its liabilities will be payable only many years in the future. *Mooney Aircraft, Inc.* held that the length of time before payment is not a factor under the "all events" test. *Id.* at 405-06.

Mooney Aircraft, Inc., however, does not leave the Commissioner powerless to deal with attempts to manipulate the tax laws by deducting expenses which will not be paid for many years. That case upheld the Commissioner's disallowance of a deduction of an expense not likely to be paid for 20 or 30 years despite its holding that the taxpayer met the "all events" test. *Id.* at 409-10. The court held that,

II. The Courts Below Properly Gave Substantial Weight To Respondent's Uncontroverted Evidence That Its Accounting Method Complies With Generally Accepted Accounting Principles.

1. Transamerica does not operate casinos. What troubles Transamerica more than Petitioner's misapplication of the "all events" test to the facts of this case is that Petitioner advocates an approach for solving accrual questions (specifically, for determining when an accrual basis taxpayer may claim a deduction for an expense it has not yet paid) which would gut the only principles used by this Court, in analogous areas, and by the lower courts to resolve accrual questions in close cases. (Br. 19-29)

Petitioner's repeated exhortations that a liability must be "fixed and absolute," "unconditional" and "final and definite" (Br. 11) contribute little or nothing to the resolution of close cases under the "all events" test. This Court, however, should resolve close technical questions of accrual accounting, as it has done in analogous areas of the tax law, primarily by considering whether the accounting method proposed by the taxpayer comports with accounting and taxation realities by properly matching the taxpayer's income and expenses in each taxable period. *See, e.g., Commissioner v. Idaho Power Company,* 418 U.S. 1 (1974). In determining whether the taxpayer's method properly matches its income and expenses, the Court should rely heavily on the financial accounting principles which are the foundation of the accrual method of accounting. *United States v. Anderson,* 269 U.S. at 440; *see also Commissioner v. Idaho Power Company,* 418 U.S. at 12-15. If, as in this case, the method of accounting adopted by the taxpayer properly matches income and expense, this Court should allow the deduction, unless the Commissioner or the United States can point to specific evidence, on the facts before the Court, which suggest that the accounting method employed by the taxpayer distorts the taxpayer's income. Since no such evidence exists here, Respondent should prevail.

The Claims Court and the Federal Circuit in the decisions below appear to have followed exactly this logic. The courts below gave particular emphasis to the principles of financial accounting applicable to Respondent in deciding whether Respondent had met the "all events" test. Respondent presented uncontradicted expert testimony that its method of accounting for progressive slot machine liabilities conforms to generally accepted accounting principles. J.A. 68-69.[2] The Claims Court, after receiving that evidence, found not only that Respondent's liability for the progressive jackpots was fixed by state law at the close of its tax year, but also that a contrary result would mismatch Respondent's income and expenses and in effect would convert Respondent "from an *accrual* basis taxpayer to a *cash* basis taxpayer." *Hughes Properties, Inc.*

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in the circumstances of that case, the Commissioner had properly determined that the taxpayer's method of accounting did not clearly reflect its income. *Id.* Under *Mooney Aircraft, Inc.*, the Commissioner thus could have disallowed Respondent's deduction on the ground that Respondent's method of accounting did not properly reflect its income under Section 446(b) of the Code if the Commissioner had had evidence that Respondent set its slot machines so that a winning pull would be unlikely to occur for many years. *Id.*; *see also Burck v. Commissioner*, 533 F.2d 768, 772 (2d Cir. 1976); *Clement v. United States*, 580 F.2d 422, 430 (Ct. Cl. 1978) (per curiam), *cert. denied*, 440 U.S. 907 (1979).

[2] *See also* Audit and Accounting Guide Prepared By The Gaming Industry Special Committee of the American Institute of Certified Public Accountants, "Audits of Casinos" (1984), at pages 11-12.

v. United States, 5 Cl. Ct. 641, 645 (1984) (emphasis in original). The court of appeals affirmed, stating:

> The taxpayer's method of accounting accurately reflects the casino's income and expenses. If we were to require that the deduction of a jackpot liability be deferred until the year of actual payment, rather than the year in which the liability accrued, it would distort taxable income for the year of payment. Here, the accounting method used by taxpayer results in allocation of the expense to the year in which the revenues were earned.

Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (1985).

Rather than applaud this practical approach to the problem, Petitioner criticizes this reasoning as ignoring the distinction between tax and financial accounting, a distinction it calls critical to a proper understanding of the role of the "all events" test in the law.[3] (Br. 20) However, it is Petitioner, and not the courts below, which misperceives the function of the "all events" test. The "all events" test is a tool to enable the Commissioner and the

[3]The Commissioner apparently does not share Petitioner's view of the distinction between tax and financial accounting. In *Orange & Rockland Utilities, Inc. v. Commissioner*, 86 T.C. No. 14, Tax Ct. Rep. (CCH) Dec. 42,884 (February 18, 1986), the Commissioner rejected an accrual basis taxpayer's non-recognition of income solely because the taxpayer recognized the same income for financial accounting purposes. The Commissioner allowed similarly situated taxpayers not to recognize the income so long as they also did not recognize the income for financial accounting purposes. The Commissioner argued that the taxpayer's recognition of the income for financial accounting purposes made its non-recognition of the same income for tax purposes an improper accounting method which the Commissioner could reject as not clearly reflecting income under Section 446(b) of the Code.

courts to implement, without serious risk to the public fisc, Congress' express desire to permit taxpayers to take advantage of scientific accounting principles in making their returns to achieve a better matching of income and expense than can be achieved by use of the cash method of accounting. *United States v. Anderson*, 269 U.S. at 440. The "all events" test does not override that goal but rather should be construed to the maximum extent feasible to further Congress' goal. *See, e.g., Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976) (per curiam), *cert. denied*, 429 U.S. 867 (1976); *W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974); *Artnell Company v. Commissioner*, 400 F.2d 981 (7th Cir. 1968).

2. The "all events" test derives from, and can only be understood in the context of, Congress' decision to authorize taxpayers to use the accrual method of accounting for purposes of calculating their federal income tax. Under an accrual method, taxpayers report income and take deductions not when they receive or make payment but when they obtain a right or incur an obligation. Congress first authorized use of the accrual method in 1916 when it became evident that the cash method of accounting "could seriously distort income — especially in a business of any complexity in which payment is frequently received in a different accounting period than that in which expenses attributable to such payment are incurred." *Mooney Aircraft, Inc.*, 420 F.2d at 403. The accrual method provides a clearer reflection of the taxpayer's income than does the cash method, "enabl[ing] taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States v. Anderson*, 269 U.S. at 440. The "very essence" of

these scientific principles of accrual accounting, now known as generally accepted accounting principles, is the proper matching of related items of the taxpayer's income and expense in the same accounting period. McClure, *Diverse Tax Interpretations of Accounting Concepts,* 142 J. Acct. 67, 71 (Oct. 1976).

The Internal Revenue Code implements Congress' choice by requiring a taxpayer to compute taxable income "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." I.R.C. § 446(a). Taxpayers may use the accrual method. I.R.C. § 446(c)(2). If the taxpayer regularly uses no method of accounting, "or if the method used does not clearly reflect income," taxable income shall be calculated "under such method as, in the opinion of the Secretary, does clearly reflect income." I.R.C. § 446(b). The Commissioner has stated:

> *A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business* in accordance with accepted conditions or practices in that trade or business *will ordinarily be regarded as clearly reflecting income*, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(a)(2) (emphasis added). Absent a countervailing tax policy, an accrual basis taxpayer claiming a deduction for an expense it has not yet paid should be allowed the deduction if that deduction reflects the consistent application of generally accepted accounting principles to the taxpayer's trade or business. *See Eastman Kodak Co.*, 534 F.2d at 258.

When a taxpayer uses an accrual method of accounting, however, it confronts the courts and the Commissioner

with a problem not posed by a cash basis taxpayer — the courts and the Commissioner must be convinced that the expense, although not yet paid, is sufficiently certain to be paid that the taxpayer should be allowed to deduct it. If deduction is proper only when payment of the expense is certain, the clearer reflection of income produced by the "scientific principles" of accrual accounting is lost. On the other hand, if deduction is proper in every instance in which the taxpayer reflects the expense in its books, the government's ability to raise money becomes subject to the unfettered discretion of taxpayers.

In *United States v. Anderson*, this Court first addressed this problem, holding that an accrual basis taxpayer should have deducted an unpaid tax on the profits from the manufacture of munitions in the year in which the profits were earned because deduction in that year clearly reflected the taxpayer's income. 269 U.S. at 442. The Court noted that even before the tax was assessed all the events had occurred which fixed the amount of the tax and determined the liability of the taxpayer for it. *Id.* Subsequently, this Court held that accrual basis taxpayers may not deduct an expense unless the events necessary to create the liability occur in the taxable year. *Brown v. Helvering*, 291 U.S. 193, 200 (1934).

The "all events" test constitutes the Commissioner's efforts, derived from *United States v. Anderson* and *Brown v. Helvering*, to crystallize what constitutes clear reflection of income when a taxpayer uses an accrual method of accounting. *Mooney Aircraft, Inc.*, 420 F.2d at 405. Treasury Regulation 1.446-1(c)(1)(ii) states:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined

> with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. *The method used by the taxpayer* in determining when income is to be accounted for *will be acceptable if it accords with generally accepted accounting principles*, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

(emphasis added).

The "all events" test could not purport to, and does not, end all the uncertainty inherent in the accrual method of accounting. Uncertainties as to the amount of liability and as to whether the liability will be paid do not preclude the taxpayer from satisfying the "all events" test.[4] *Denise Coal Co.*, 271 F.2d at 935-36. In close cases under the "all events" test, the courts must decide whether the level and character of the uncertainty that the taxpayer will pay the expense justifies the Commissioner's determination that deduction of the expense does not clearly reflect the taxpayer's income.

3. As Treasury Regulation § 1.446-1(c)(1)(ii) illustrates, the "all events" test constitutes a refinement of the scientific principles of accrual accounting designed to protect the public fisc against depletion from deductions

[4]The quote from *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979), relied upon heavily by Petitioner (Br. 24), that the tax law "with its mandate to preserve the revenue, can give no quarter to uncertainty," is simply wrong. This Court should take this opportunity to clarify that statement which has misled many courts considering accrual accounting questions. Transamerica will address *Thor Power Tool Co.* in detail in Section III of this brief.

of expense which may never occur. Generally accepted accounting principles, as the scientific accounting principles which first led Congress to authorize use of the accrual method are now called, remain an important guide to what constitutes proper accrual accounting. *Boise Cascade Corp.*, 530 F.2d at 1372. In some circumstances, most particularly those where generally accepted accounting principles require the creation of a reserve for contingent liabilities, this Court has explicitly deviated from financial accounting principles because the level of uncertainty that the expense will be incurred and paid by the taxpayer is simply too great to permit the deduction. *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944) (disallowing deduction for contested tax liability; tax in fact was never paid).

In close accrual accounting cases, however, the "all events" test has proven not to provide any independent rationale for distinguishing between fact situations. Lower courts have, in situations such as these, struggled to find some principled rationale to guide them in determining whether accrual of an as yet unpaid expense would be proper. As the court stated in *Flamingo Resort, Inc.*:

> [T]he courts have not developed a formula that can be applied mechanically to any given fact situation to determine whether accrual is proper or not. Rather the courts have attempted to apply the "all events" test in a manner that recognizes the realities of a given transaction. . . . [W]hether a right is fixed and the amount thereof determinable depends upon "a practical rather than a legal test."

485 F. Supp. at 936 (citations omitted). Other courts have stated that "all events" issues must be viewed "in the light of realism and practicality." *Travis v. Commissioner*, 406 F.2d 987, 990 (6th Cir. 1969), quoting *Commis-*

sioner v. Segall, 114 F.2d 706, 709 (6th Cir.), *cert. denied*, 313 U.S. 562 (1940). Still others have announced that "the proper approach to [an "all events"] problem . . . should be realistic and one that accords with good business practice, rather than an approach based upon subtle technicalities." *Harrold*, 192 F.2d at 1006.

Moreover, commentators have recognized that rigid application of the "all events" test in close cases can produce a mismatching of related revenues and expenses seriously undermining the purpose of the accrual method of accounting, a consequence which has brought such applications into disfavor with Congress, the Service and the courts. Dubroff, Cahill and Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 Alb. L. Rev. 354, 401-02 (1983).

Transamerica believes the answer to this dilemma is clear. The courts should resolve the clear reflection of income question presented in close "all events" test cases by looking to the fundamental purpose of the accrual method of accounting, *i.e.*, the use of "scientific accounting principles" to "charg[e] against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States v. Anderson*, 269 U.S. at 440.

This Court has recognized in the analogous area of depreciation accounting, where the purpose of the accounting technique is also to match expenditures to the specific accounting period benefitted by those expenditures, that sound accounting principles must be given great weight in resolving technical issues under the Internal Revenue Code. *Commissioner v. Idaho Power Company*, 418 U.S. at 10-16. In that case, this Court held that

a taxpayer must depreciate capital equipment used in the construction of its own capital facilities over the life of the capital facilities constructed rather than over the shorter life of the equipment. In reaching this conclusion the Court relied heavily on financial accounting principles, noting: "Our primary concern is the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities." *Id.* at 10.

The Courts of Appeal, including the court below, have given tremendous weight to evidence that a taxpayer's method of accounting accords with the accounting profession's view of how income should be reflected in that taxpayer's trade or business when determining in accrual cases whether recognition of income or allowance of a deduction clearly reflects the taxpayer's income. *Boise Cascade Corp.*, 530 F.2d 1367; *W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974); *Artnell Company v. Commissioner*, 400 F.2d 981 (7th Cir. 1968); *Pacific Grape Products Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955). Numerous other lower courts, in other contexts, have used precisely the same analysis to resolve questions of whether a taxpayer's method of accounting for a particular item clearly reflects its income under Section 446(b). *See, e.g., Transwestern Pipeline Co. v. United States*, 639 F.2d 679, 681 (Ct. Cl. 1980); *Molsen v. Commissioner*, 85 T.C. 485 (1985); *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 286 (1967).

This approach has created no danger to the public fisc. In situations where the "all events" test quite clearly has not been met, the courts have upheld the Commissioner's disallowance of the taxpayer's deduction. *Supermarkets General Corp. v. United States*, 537 F. Supp. 759 (D.N.J. 1982). In closer cases, the courts have been heavily

influenced by financial accounting principles. *See, e.g., W.S. Badcock Corp.,* 491 F.2d at 1228. Where, despite the conclusion that the taxpayer's method of accounting conforms to generally accepted accounting principles applicable to its trade or business, the Commissioner can show, on the specific facts of the case, that payment of the expense will be too remote in time or that no reasonable expectancy exists that the expense will be paid, the courts have held that the Commissioner still has the power to reject the taxpayer's deduction as not clearly reflecting income. *Mooney Aircraft, Inc.,* 420 F.2d at 409-10; *Clement,* 580 F.2d at 430. This approach to technical questions of accrual accounting allows the accrual method of accounting authorized by Congress to survive. It also gives the Commissioner sufficient powers to root out manipulation of the tax laws and prevent any loss to the public fisc from the uncertainty inherent in the accrual method.

This case itself demonstrates that the approach adopted by the lower courts poses no danger to the public fisc. Petitioner puts forward alleged "contingencies" which it concedes are "extremely remote and speculative," arguing that "there is no reason to believe that the odds against their happening . . . differed appreciably from the odds against a customer's winning the jackpot on a progressive slot machine programmed to pay off (say) at 'one chance in 9,725,625.' " (Br. 13) Whether the uncertainty here is an uncertainty as to Respondent's liability itself (as Petitioner argues) or an uncertainty only as to payment (as Transamerica believes), an uncertainty which even Petitioner suggests will occur roughly one time in ten million poses no danger to the public fisc. This Court should not allow Petitioner to sabotage the very underpinnings of the accrual method of accounting sanctioned by Congress to avoid a one in ten million bet. The Commissioner after *Mooney Aircraft, Inc.* has sufficient weapons under Section 446(b) to deal with even that one instance.

4. Congress has also expressed its preference for greater harmony between this area of the tax law and generally accepted accounting principles. In 1954, Congress added sections 452 and 462 to the 1954 Code, permitting accrual method taxpayers to defer the recognition of prepaid income until it was earned and to deduct anticipated expenses not otherwise accruable under the "all events" test. The stated purpose of Congress in enacting these provisions was to bring "[t]ax accounting . . . more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. No. 372, 84th Cong., 1st Sess. 3, *reprinted in* 1955 U.S. Code Cong. & Ad. News 2046, 2048.

The following year, sections 452 and 462 were repealed at the request of the Treasury Department, solely because it was feared that the revenue loss in the transition year would greatly exceed original estimates.[5] Congress made every effort to ensure that the repeal would not be construed as a rejection of financial accounting principles for tax purposes. The Senate Committee report concluded: "[Y]our committee believes that it is essential

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[5]Bersh and Nadel, *The Dilemma of Conformity — Tax and Financial Reporting,* 36 Inst. on Fed. Tax'n, 529, 532 n.7 (1978). Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 361, Cohen, *Accounting for Taxes, Finance and Regulatory Purposes — Are Variances Necessary?,* 44 Taxes 780, 790 (1966). Many commentators now believe that the excessive revenue loss could have been prevented with the use of proper transitional rules. *See, e.g.,* Bersh and Nadel, 36 Inst. on Fed. Tax'n at 532, Kurtz, *A Challenge, Can the Accounting Profession Lead the Tax System?,* 126 J. Acct. 66, 69 (Sept. 1968).

that the income tax laws be brought into harmony with generally accepted accounting principles." S. Rep. No. 372, 84th Cong., 1st Sess. 5, 6, 1955 U.S. Code Cong. & Ad. News at 2051. The House Committee report stated "Your committee is in accord with the general principle that tax accounting should be brought into harmony with generally accepted principles of business accounting since the latter generally reflect more accurately the timing of receipt of income and of incurring of expenses." H.R. Rep. No. 293, 84th Cong., 1st Sess. 3, *reprinted in* 1955-2 C.B. 852, 854.

Congress also expressed its hope that the courts would continue the trend towards harmonizing the tax laws with the generally accepted accounting principles established in *Pacific Grape Products Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955) (permitting accrual of anticipated freight and shipping expenses in tax year preceding payment in accordance with the financial accounting practice of the California canning industry) and *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955) (permitting deferral of prepaid subscription income in accordance with the taxpayer's method of financial accounting). Regarding *Pacific Grape Products Co.*, the Senate stated: "An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." S. Rep. No. 372, 84th Cong., 1st Sess. 5-6, 1955 U.S. Code Cong. & Ad. News at 2051. The Secretary of the Treasury informed the House Ways and Means Committee that the "repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462

had never been enacted." H.R. Rep. No. 293, 84th Cong., 1st Sess. 5, 1955-2 C.B. at 855.[6]

III. Petitioner's Reliance On *Thor Power Tool Co. v. Commissioner* And *American Automobile Ass'n v. United States* Is Misplaced.

1. Petitioner relies on *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (*"Thor"*) for the proposition that the goals of financial accounting and tax accounting are too divergent to accord weight to financial accounting principles in this case. However, a closer look at *Thor* reveals that the Court's statements regarding the differences between tax and financial accounting are overbroad and also inapplicable to the facts of this case.

In *Thor*, the taxpayer wrote down "excess" inventory to an estimated below market value based on an "educated guess" that the inventory would not be sold. The write-down, while apparently in accordance with generally accepted accounting principles, was inconsistent with treasury regulations permitting such write-downs only where the inventory concerned was either defective or offered for sale at its reduced value. *Thor* did not involve the application of the "all events" test.

Because the taxpayer in *Thor* did not fall within either of these exceptions, and in fact failed to provide any

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[6]The negative inferences drawn from the repeal of sections 452 and 462 by a five member majority of this Court in *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), and by Petitioner in this case (Br. 25-26), are flatly contradicted by this legislative history. Indeed, even commentators hostile to the influence of financial accounting principles in the tax law have conceded that the dissent's argument against drawing any such inferences in *American Automobile Ass'n*, 367 U.S. at 704-710, "seems compelling on this point." Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1, 16 n.77 (1984).

objective evidence whatsoever of the reduced value of its excess inventory, the Court held the write-down to be "plainly inconsistent with the governing Regulations" and on that ground rejected it. *Id.* at 533.

Thor presented a glaringly bad fact situation. The regulations permitted the taxpayer to write down its "excess" inventory only if it offered that "excess" inventory for sale and used the bid price to determine its value. Treas. Reg. § 1.471-2(c)(1). Despite having failed to comply with the Regulations, the taxpayer wrote down its excess inventory. It presented no evidence that the value it selected represented the true market value of the "excess" inventory. *Thor,* 439 U.S. at 536. In fact, it continued to sell pieces of its "excess" inventory at prices far higher than the reported value of its inventory on a piece by piece basis. *Id.* To allow the write-down under those circumstances would have been, as the Court put it, tantamount to allowing the taxpayer to "determine how much tax it wanted to pay." *Id.* Unfortunately, however, the blatant facts of the taxpayer's attempted write-down in *Thor,* together with the apparent acceptability of the write-down under the particular financial accounting principles involved in that case, led the Court, in dicta, to make some overbroad generalizations about the weight properly to be accorded to generally accepted accounting principles in every case.

The Court in *Thor* placed great emphasis on the "vastly different objectives that financial and tax accounting have." *Id.* at 542. In fact, as many commentators have observed, the objectives of financial accounting principles and the tax code largely coincide. Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 390; Nolan, *The Merit of Conformity of Tax to Financial Accounting,* 50 Taxes 761, 769 (1972); Kurtz, 126 J. Acct. at 68. Both tax and

financial accounting are directed at achieving the clearest possible reflection of periodic economic income. It is precisely because of this fundamental identity of objectives that Congress directed taxpayers to compute taxable income in accordance with the accounting method used in keeping their books. I.R.C. § 446(a). Were the objectives of tax and financial accounting indeed so "vastly" disparate, the Court in *Thor* could not have stated as it did that "in most cases, generally accepted accounting practices will pass muster for tax purposes." 439 U.S. at 540.

Thor also stressed the conservatism of financial accounting and its purported tendency to understate income, contrasting this with the Treasury's responsibility to protect the public fisc. *Id.* at 542-43. However, while it cannot be disputed that conservatism is a basic component of financial accounting, conservatism does not connote the deliberate, consistent understatement of profits that *Thor* seems to suggest. A company whose stock is publicly held can violate the federal securities laws just as easily by being too pessimistic about its operations as by being too optimistic. *SEC v. Texas Gulf Sulphur,* 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971). Financial accounting principles do not permit deferring recognition of income beyond the time that adequate evidence of its existence becomes available, nor do they justify recognizing expenses before there is adequate evidence that they have been incurred. Financial Accounting Standards Board, Statement of Financial Concepts No. 2: Qualitative Characteristics of Accounting Information, ¶95, *reprinted in* Financial Accounting Standards Board, Accounting Standards, Original Pronouncements as of June 1982 at p. 3064.

In effect, financial accounting's "conservatism" constitutes a check on the natural tendency of those involved in a business to see it through rose colored glasses. Tax accounting's "clear reflection of income" principle operates as a check on the equally natural tendency of those involved in a business not to pay more in taxes than they believe to be absolutely necessary. Both accounting principles, however, have the same objective: to clearly reflect periodic income by charging against income earned in a period the expenses incurred in and properly attributable to the process of earning that income. *United States v. Anderson,* 269 U.S. at 440.

Moreover, the arguments raised in *Thor* were directed at the use of generally accepted accounting principles as a substitute for the specific inventory accounting rules set out in the Code and Regulations, rather than at their use as an aid to the proper application of those rules in close cases. *Thor* did not even address the application of the "all events" test let alone whether financial accounting principles should be given weight in resolving close questions under that test. Where the Commissioner cannot demonstrate with certainty that a taxpayer has failed the "all events" test and where, in addition, payment of the liability is, in the opinion of the accounting profession, so likely to occur that failure to accrue the liability currently will materially distort income, the threat to revenue collection perceived in *Thor* does not materialize. Moreover, the Commissioner's power under Section 446(b) to disallow deductions of expense when specific evidence exists that a taxpayer is unlikely to pay those expenses represents a further guarantee against that threat.

Thor also questioned the suitability of financial accounting principles for tax accounting purposes because these principles do not always provide a single accounting

treatment for each economic event, and because they frequently make use of "estimates, probabilities and reasonable certainties." 439 U.S. at 543-44. However, as commentators have pointed out, this argument "fails to acknowledge the diversity of accounting treatments allowed by the Code, and the number of estimates and subjective judgments required in applying the Code." Dubroff, Cahill & Norris, 47 Alb. L. Rev. at 405 n.158. In the depreciation area, for example, the Code requires the use of estimates based on probabilities to determine the useful life of assets and their salvage value. The valuation of property under various Code provisions also requires estimates and subjective judgments. *E.g.,* I.R.C. § 170 (charitable deductions). In the "all events" area, a reasonable estimate of the amount of an anticipated liability is required, and the question of when a liability has become sufficiently "fixed" to permit its deduction frequently calls for the exercise of judgment. Treas. Reg. § 1.446-1(c)(1)(ii).

The objections cited above to the application of generally accepted accounting principles in the area of tax accounting are particularly inapposite in the instant case. Financial accounting principles do not permit a wide range of permissible treatments for the accrual of anticipated liabilities. Such liabilities may be accrued only where incurrence of the liability is "probable", *i.e.,* when future events confirming the fact of liability are likely to occur. While some exercise of judgment may be required in interpreting the word "probable" under this test, the degree of judgment called for is no greater than that required under the "all events" test in determining when the fact of liability has been established. Moreover, no exercise of judgment whatsoever is required to apply the unambiguous casino accounting rule that progressive jackpots are to be accrued "as the amount of the jackpot

increases."[7] Indeed, the degree of subjective judgment required by the "all events" test far exceeds that required by the applicable financial accounting rule in this case. If the tax law indeed can "give no quarter to uncertainty", *Thor,* 439 U.S. at 543, then the financial accounting rule must be followed here.

Finally, *Thor* made passing reference to the "ability to pay" principle in justifying its refusal to apply a presumption in favor of generally accepted accounting principles. This principle requires that income be reported on receipt, when the taxpayer has the funds to pay. The principle is faulty, because it requires taxpayers to report as income what is really debt capital, thus imposing a heavy and unjustified burden on the financial structure of many taxpayers. Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 405 n. 158.

Closely related to the "ability to pay" argument is the "unrestricted use of funds" argument raised by Petitioner. (Br. 28) Petitioner contends that because Respondent has the "use and enjoyment" of progressive jackpot amounts before they are paid out to a lucky gambler, Respondent, therefore, should be required to pay a tax on these amounts. The argument is specious. Respondent's ability to use the jackpot amounts is irrelevant to the issue of whether they should be taxed. Any taxpayer which borrows money obtains the unrestricted use of funds. Respondent's jackpot amounts represent accrued liabilities. As such these amounts are similar to debt capital, which is properly subject to a "borrower's" "use

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[7]Audit and Accounting Guide Prepared By The Gaming Industry Special Committee of the American Institute of Certified Public Accountants, "Audits of Casinos" (1984), at page 12.

and enjoyment" without any tax first having to be paid thereon.

2. Petitioner concedes that Respondent's method of accounting "results in allocation of the expense to the year in which the revenues were earned" (Br. 24) but contends that proper matching "does not control the outcome here." *Id.* To support this assertion Petitioner relies on a one-line synopsis by the Court in *Thor* of the holding in *American Automobile Ass'n v. United States,* 367 U.S. 687 (1961). *Thor,* citing *American Automobile Ass'n,* states: "a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of 'generally accepted commercial accounting principles'." 439 U.S. at 541. However, this synopsis of *American Automobile Ass'n* is inconsistent with the Court's reasoning in that case.

In *American Automobile Ass'n,* the taxpayer reported income from annual prepaid automobile club membership dues in ratable monthly amounts over the year of membership. In so doing, the taxpayer sought to match the dues income with the anticipated costs of providing the services for which the membership dues had been paid.

The Court rejected this accounting method as "artificial", 367 U.S. at 691, but not, as petitioner suggests, because the Court found matching an irrelevant principle. Rather, the Court found that the taxpayer's accounting method did not match income with related expenses closely enough. *Id.* at 692, 694. The equal monthly installments to which the taxpayer allocated each month's membership dues were "not in fact related to the expenses incurred." *Id.* at 692, 693. This mismatch occurred because, as in *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1957), "substantially all services [were] performed only upon a member's demand and the tax-

payer's performance was not related to fixed dates after the tax year [citation omitted]." *American Automobile Ass'n,* 367 U.S. at 691. Consequently, the expenses incurred in such performance varied considerably from month to month while recognition of income under the taxpayer's method of accounting "nonetheless remain(ed) ratably constant." *Id.* at 693.

American Automobile Ass'n thus held, not that matching is irrelevant in determining the acceptability of an accrual-basis taxpayer's accounting method for tax purposes, but that the taxpayer there had failed to present evidence that its proposed matching clearly reflected its income. The Court rejected an accounting method which gave the taxpayer discretion to choose when it would recognize income because the taxpayer's choice did not demonstrably relate to the time when the expenses associated with the earning of that income would be incurred. The holding in *American Automobile Ass'n* implies that had the accounting method employed by the taxpayer restricted such discretion by requiring a clearer and more direct relationship between the accrual of income and related expenses, it would have been upheld. In fact, subsequent cases have allowed deferral of prepaid income when future services are scheduled for fixed dates or can otherwise be matched with payments on a closer basis. *Boise Cascade Corp.,* 530 F.2d at 1369-70, 1376-78; *Artnell Co.,* 400 F.2d 981.

In the instant case the requirements of *American Automobile Ass'n* are met because there could be no closer matching of related income and expenses, and because no exercise of discretion on Respondent's part is involved. As gamblers deposit coins into progressive slot machines, the casino recognizes income. Simultaneously and automatically, the expenses attributable to the earning of that

income are registered on the progressive slot machine indicator. The matching is demonstrable and exact: The precise cost of earning the income taken in by each progressive slot machine is accrued as the income is earned. Respondent thus eliminates the "artificial" separation of income accrual from the incidence of related expense which so troubled the Court in *American Automobile Ass'n.*

CONCLUSION

Petitioner's contention that Respondent has failed to meet the "all events" test hinges on Respondent's inability to identify a specific gambler who could make a claim and on Respondent's ability to avoid a claim by ceasing its casino operations. For the reasons stated herein, Transamerica Corporation believes this argument is incorrect and urges this Court to affirm the judgment of the United States Court of Appeals for the Federal Circuit.

Respectfully submitted,

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PROOF OF SERVICE BY MAIL

I am a citizen of the United States and a resident of the City and County of Los Angeles; I am over the age of eighteen years and not a party to the within action; my business address is: 1706 Maple Avenue, Los Angeles, California.

On March 3, 1986, I served the within Amicus Curiae Brief in re: "United States of America -v- Hughes Properties, Inc." in the United States Supreme Court, October Term 1985, No. 85-554;

on the parties in said action, by placing 3 copies thereof enclosed in a sealed envelope with postage fully prepaid, in the United States post office mail box at Los Angeles, California, addressed as follows:

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All Parties required to be served have been served.

I certify (or declare), under penalty of perjury, that the foregoing is true and correct.

Executed on March 3, 1986, at Los Angeles, California

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